REIT PRIVATE PLACEMENT: INVESTMENT OPPORTUNITY FOR PENSION FUNDS?

by John McMahan, CRE

The capitalization of Real Estate Investment Trusts (REITs) has grown at a remarkable rate over the last five years as investors sought to capitalize on advantageous pricing opportunities in real estate. As these opportunities have dwindled, investors are shifting their focus to participation in the future economic growth of geographic areas and property types through investment in companies with the ability to add value through development, redevelopment and active management.

This shift reflects a broader, more fundamental shift in the role of REITs—from passive investment vehicles to real estate operating companies. To attract investors, REITs must have a strategy for future growth in shareholder value and the management resources for successful implementation. Due to the high cash payout ratios required to maintain their favorable tax status, however, REITs cannot retain any meaningful amount of earnings to finance these strategies. Therefore, if they are to deliver what investors are expecting, REITs frequently must return to the capital markets for needed funds.

Largely as a result of increasing interest rates and a torrid financing pace over the last three years, public capital markets are closed to many REITs and are expected to remain so for some time. Private placement financing—mostly in the form of equity—will be a major source of new REIT capital during this period. However, traditional institutional sources of private placements—commercial banks, insurance companies and private investors—are limited in their ability to provide REITs with private placement financing. Pension fund investors may have a unique opportunity to fill this need and, in so doing, realize solid returns with moderate risk.

This article explores how this situation developed, why REITs will desire private placement financing, who will provide the funds, who will be the intermediaries and the underwriting and monitoring considerations involved.

Historical Perspective

REITs didn't start out to be go-go operating companies with high expectations for future growth in earnings. In 1960, the changes in the Internal Revenue Code, which established special REIT tax treatment, envisaged a conservative investment vehicle

John McMahan, *CRE, is a real estate investor and consultant. Previously, he was chairman of the 15th largest real estate pension advisory firm and served as chair of the National Association of Real Estate Investment Managers (NAREIM). McMahan managed a public REIT for five years and currently is chairman of two public REIT boards. He is an adjunct professor at the Haas Graduate School of Business, University of California, Berkeley, and he formerly taught at the Stanford Graduate School of Business.*

with pass through features which would encourage long term investment in real estate by individual, taxable investors. Less than half the REITs operating in the 1960s were self-advised (internally managed; no external advisor) and, even in these cases, management did not participate extensively in stock ownership. There was little market activity and not much research coverage by the financial community.

In the late 1960s, REIT Initial Public Offerings (IPOs) shifted from an emphasis on long term equity investment to short term mortgage investment, largely in the form of construction and development loans. Mortgage REITs were the largest single source of capital funding for the 1971-1975 real estate boom, borrowing short and lending long in order to arbitrage the yield curve. This bubble collapsed in 1973-1974, and REITs became tarred with a negative image which has only been overcome in recent years.

Largely as a result of this debacle and the tax advantages of limited partnership financing prior to 1986, REITs missed the real estate boom/bust cycle of the 1980s. With the collapse of real estate markets at the end of the decade, most forms of capital for real estate evaporated. Developers and other owners of real estate found themselves with highly leveraged properties often built with short-term financing and few sources of refinancing. With interest rates falling and real estate yields rising, Wall Street saw an opportunity to arbitrage private and public markets.

The Kimco offering in 1991 was the first sign that REITs could play a major role in financing real estate and, more importantly, real estate operating companies. During 1991, eight initial public offerings (IPOs) involving REITs raised $808 million. A similar number were completed in 1992, raising $919 million.

The Class Of 1993

While this represented a meaningful capital raising activity, particularly in a capital-starved real estate market, 1993 proved to be the real turning point—82 equity issues raised $12.1 billion. Compare this with 62 issues raising $3.7 billion over the prior five years combined!

Perhaps more significant, the character of the 1993 IPOs was dramatically different. Virtually all the IPOs represented real estate operating companies, specializing by property type. The new REITs also were significantly larger—ten equity REITs had market capitalization of over $500 million (versus two at the end of 1991), and 40 had capitalization exceeding $200 million (versus 10 in 1991).

Almost all the 1993 IPOs were self-administered and self-managed and, in many cases, management had significant equity positions which minimized conflicts and enhanced congruency with investors. Most of the management groups had spent their careers specializing in the particular property type and had worked together effectively as a team for many years, including at least one full real estate cycle. In essence, they were fully-integrated, real estate operating companies.

The momentum of 1993 continued into the first nine months of 1994. Over $10.0 billion in equity capital was raised for a widely divergent group of firms. New property types were added (e.g., outlet centers, hotels, golf courses, net leased properties, etc.) and geographical coverage extended to parts of the country not previously represented.

The Modern REIT

Although regulations have loosened considerably over the years, REITs still must meet several fairly stringent rules if they are to maintain their REIT status and avoid taxation at the corporate level:

- Seventy-five percent of assets must be in real estate equity, mortgages, REIT shares, or cash.
- Seventy-five percent of annual income must come from rents or mortgage interest. No more than 30% of annual gross income can come from the sale of properties held less than four years.
- Ninety-five percent of taxable income must be paid out annually.
- REITs must have at least 100 shareholders. Five individuals cannot own more than 50% of the stock (5/50 rule).[1]

In terms of organization, all REITs must be a corporation or a trust which is managed by a board of directors or trustees. For publicly traded REITs, the majority of trustees must be independent of REIT management. In fact, any major conflict of interest is usually penalized through share pricing.

As a pass-through vehicle, REITs should be expected to trade on the yield of underlying real estate assets, less a liquidity discount. However, today some REITs sell at premiums over the underlying yield, largely in anticipation of earnings growth through development, refinancing or restructuring investments. Often referred to as "enterprise value," this reflects the premium added by good management. The demand for REIT shares also is influenced by dividend spreads over treasuries (institutional investors) and money market funds (retail investors).

Earnings usually are measured in terms of funds from operations (FFO) which is net income (according to GAAP), excluding capital gains, plus depreciation and amortization. Stock prices increasingly are compared to FFO flows, much the same as

price/earnings ratios for non-real estate stocks.[2] Other factors that analysts and investors track are payout ratios (percent of distributable income that will be paid out as dividends), total debt to total capitalization (the market doesn't like leverage exceeding 45%), and the proportion of floating debt in the capital structure.

REIT Dependence On Capital Markets

With modern REITs, the good news and the bad news are the same—REITs are largely dependent upon capital markets for investor-anticipated growth. This is good news in that REITs have a great deal of market flexibility in terms of how they access the capital markets (e.g., corporate and property debt/equity), certainly more than other types of real estate companies. It is bad news, however, in the sense that if they are going to grow in an environment of high annual earnings payout ratios, REITs are forced to go to the capital markets.

In years such as 1993 and the first half of 1994 when the REIT IPO markets were hot, securing secondary financing on reasonably favorable terms was not difficult. Almost $5.0 billion in secondary equity offerings (41.2% of total equity raised) were placed during this period. This situation was enhanced, of course, by the presence of historically low interest rates. As 1994 unfolded and interest rates continued to rise, the REIT IPO market dried up and with it, the secondary market. Secondary issues during the last quarter of 1994 fell to $201.6 million, off substantially from the $1,051.0 million average for the first three quarters.

The near term future appears to be more of the same. A considerable amount of floating debt taken on by the REITs will need to be refinanced over the next few years. Some REITs, particularly those founded by developers, may need to liquefy the positions of large single investor ownership. Smaller REITs may need to bulk up in order to avoid being taken over by larger REITs. For those that consolidate, capital may be required to extinguish or restructure old debt in order to complete the transaction.

The REIT capital market over the next few years should be marked by a great deal of turmoil as firms struggle to balance shareholder pressure for continued growth with prudent balance sheet management. As in most periods of market turmoil, investment opportunities are created. A significant opportunity over the next few years will be to provide private market solutions to public market diseconomies.

Who Will Supply The Capital?

Traditional suppliers of private placement capital include banks, insurance companies and private investors. Commercial banks are primarily oriented toward debt financing, generally on the corporate level, to avoid adverse mortgage-related risk capital requirements. The balance sheets for a large number of REITs will make it difficult for them to take on additional debt. For those that can, the cost may be prohibitively expensive.

Insurance companies undertake both debt and equity placements. As noted above, debt financing opportunities will be limited. With much tougher rating requirements, most insurance companies also must be careful when adding real estate equity investments to their balance sheets, even though the security status of REIT shares makes this cosmetically plausible. On balance, the outlook is for a limited number of conservatively financed insurance companies to be active in the equity private placement market.

Private investors will no doubt be active in the REIT private placement market, mostly through large venture pools originally organized to take advantage of pricing opportunities in the securitized debt market. With fewer of these opportunities available, these pools are logically positioned to move into the equity financing area. A big question, however, is the extent to which their investors, who are used to phenomenal returns and short turnarounds, will adjust to longer holding periods and somewhat lower (but still attractive to institutional investors) levels of return.

With limitations on the level of activity from traditional private placement players, pension funds emerge as a logical provider of badly needed REIT private placement capital. Real estate property markets have bounced-back from the severe depression of the last few years, at a time when investment opportunities in the stock and bond market are limited. Purchasing a position in a REIT, possibly at a discount to underlying real estate values, is a relatively efficient way to participate in the future of real estate.

Large pension funds, the most likely private placement players, often are interested in obtaining unique investment positions in order to use their sizable capital base and longer term investment horizon to achieve higher investment returns. As public vehicles, REITs also offer pension funds the corporate guidance, investor/manager goal congruence and ultimate liquidity that is lacking in private real estate markets.

Who Will Be The Intermediaries?

Investment banking firms can be expected to play a major role as intermediaries in REIT private placement financing. Wall Street firms, in their position as bankers to the REITs, will control a large part of the potential deal flow and no doubt will initiate many of the transactions. Investment bankers also will play a major role in the consolidation of the

REIT industry, a potential source of private placement transactions. Several firms also will be investing on their own account or through pools they control.

Since most Wall Street firms are not investment fiduciaries, pension funds will have to decide whether or not to invest through an investment manager. Some of the larger pension plans, many with competent security and/or real estate investment staff, may choose to invest directly and not delegate the fiduciary role. Most plans, however, will wish to have a fiduciary involved in the process. The question is, who will this be?

Pension fund plans viewing REITs as a security will no doubt invest through their small cap managers. In fact many plans, which already have sizable positions in REITs through their managers' prior activities, feel comfortable proceeding in this manner. Several of the small cap managers have beefed up their real estate analytical skills, although this has been mainly in the publicly traded securities area which does not contemplate the diligence required in private placement financing.

A relatively new player, real estate mutual fund advisors, have placed private equity funds in the past and reportedly have sizable amounts of capital to invest. These firms, however, face the problem of representing an investor base of both retail and institutional investors. At a minimum, this diverse base is difficult to manage, and, at the extreme, may represent serious goal incongruencies (e.g., tax vs. tax exempt status, long vs. short term hold, etc.). Also, the largely retail investor base is rate sensitive and is currently redeeming mutual fund holdings as interest rates on competing money market instruments (some FDIC insured) become more attractive.

A few traditional pension real estate advisors have established security investment groups within their organizations and have raised pension capital for REIT investment. These firms can be expected to play a major role in the private placement arena, because they have not only the confidence of their pension clients but also the staff necessary to undertake property level diligence in a relatively short time frame.

There is also the possibility that new firms will emerge that combine the real estate underwriting skills of the traditional real estate managers with a broader understanding of security analysis and REIT management. With structures similar to venture capital investment firms, these entities would invest their own funds side-by-side with their pension clients.

Investment Instruments

Private placements can take the form of debt, hybrid debt and all equity vehicles. Debt vehicles may be secured by portfolio assets on either an individual or pooled basis. Unsecured debt can be structured in the form of bonds or debentures with a wide variety of amortization, pre-payment and call features. Hybrid instruments, such as convertible bonds or preferred stock, afford an opportunity for investors to realize the security of debt financing with an opportunity to participate in the firm's future growth.

Most of the opportunities, however, will be in form of equity investments. For the most part, these will take the form of private placement stock available for later public distribution. Liquidation alternatives would be quite extensive including public sale, private sale, trade, etc. Positions could be liquidated partially or in total, although some investors may choose to hold the stock for long term appreciation.

Given the desperate need of many REITS for capital and the lack of practical alternatives, pension investors should be able to obtain discounts from the public market price, generally in the 2.0%-5.0% range, but, in some situations, possibly higher. This discount could be taken in the form of less capital for the same amount of stock or a greater amount of stock for the same amount of capital. Additional stock could be available to the extent that third-party fees are avoided or reduced.

Ownership Vehicles

As previously discussed, some pension funds may choose to hold the privately placed securities directly in their small-cap portfolios. However, this approach makes it more difficult to diversify portfolios, and participation in larger placements may not be prudent. There is also a considerable amount of ongoing monitoring required to make sure the investment is proceeding as planned and to determine when and in what manner to liquidate.

As a result of these problems, many investors may prefer investment pools. These pools most likely will take the form of private REITs or limited partnerships similar to those utilized in the venture capital arena. Since the sponsors of limited partnerships will be investing their own money, this vehicle provides the additional attraction of a congruent goal environment with pension fund partners. Regardless of the ownership vehicle ultimately selected, the key role played by the manager will be to rigorously underwrite the investment, monitor its progress and determine the appropriate time and method of liquidation.

Underwriting Investments

The successful underwriting of REIT private placements requires a skillful blend of real estate and

security skills, as well as a fundamental understanding of successful REIT management. An appreciation for the quality of the underlying real estate portfolio is essential to successfully forecast the long term growth prospects of the REIT and to evaluate pricing alternatives. This means an underwriting of every significant asset in the portfolio. In most cases, this will require a visit to the property and an evaluation of where it stands in its individual market and its future prospects for growth, including an identification of an exit strategy.

Real estate skills are critical since many investments will be in situations where the public price of the stock is less than or equal to net asset value per share. Determining the net asset value of the portfolio therefore, will be an important component of the underwriting. Finance skills also will be essential to understand how each element of the REIT's capital base (both debt and equity) is structured and will interact under various economic scenarios. Various alternative methods of structuring the private placement must be analyzed in order to come up with the optimum arrangement for both investors and the REIT.

A critical third element will be an assessment of REIT management and its capacity to grow the firm over time. This will require extensive interviews not only with senior management but with those responsible for acquiring, developing and managing the property portfolio. Discussions will be required with investment bankers, stock analysts, rating agencies, vendors and competitors.

Monitoring Investments

An easy, but potentially dangerous, assumption is that REIT private placements, being securities, can be put on the shelf and reviewed only when its time to sell. More realistically, these investments should be treated like venture capital investments and carefully monitored over the holding period.

Since pension investors may be one of the largest shareholders, continuing contact with REIT management is essential. Strategic management initiatives should be reviewed and considered in terms of their impact on long term value. Procedures should be established to independently verify the quality and value of the underlying assets. New financing and restructurings should be analyzed in terms of their impact on the investor's position. Obviously, mergers and acquisitions must be evaluated on similar terms.

One of the most important aspects of monitoring will be the decision to liquidate the position. This decision may be limited by security restrictions in the early years, but ultimately a wide variety of alternatives could emerge. Investors may choose to sell all or part of their position, either at a single point or staggered over a period of time. Stock trades may be possible as well as asset trades for those plans with direct investment portfolios. Investors in pools may choose to take direct possession of their stock rather than cash distributions.

Each of these monitoring activities will require a continuing capability in each of three essential underwriting areas—real estate, securities and REIT management. How pension plans insure that these capabilities are present will differ, but if they are not present, investors risk losing much of the advantage bargained for at the time of underwriting.

There seems to be no question that REITs are entering a new era. What it will bring can only be conjecture at this point. Given the shift in basic investment relationships, however, it will no doubt be dynamic and full of opportunities for resourceful investors. For pension funds, private placement financing should prove to be one of the more interesting opportunities over the next few years.

NOTES

1. Recent legislation clarified that, in the case of pension funds, the IRS must look through to the plan beneficiaries as being the REIT shareholders. This is in contrast with the earlier view that the plan counted as a single shareholder.
2. Although widespread, the use of FFO is criticized for not taking into consideration the cost of capital improvements. In order to overcome this problem, there is a current move to supplement FFO with Capital Available for Distribution (CAD), also referred to as Funds Available for Distribution (FAD).